

**Statement of the
Fair, Isaac and Company Inc.
To the Office of Financial and Insurance Services**

2002 Public Hearings

Fair, Isaac is a global provider of custom analytics and decision technology. Widely recognized for our pioneering work in credit scoring, Fair, Isaac revolutionized the way lending decisions are made. Today the company helps clients in multiple industries, including the insurance industry, make more objective, consistent, and efficient decisions that increase the value of customer relationships.

For purposes of this statement, Fair, Isaac will be discussing Fair, Isaac-developed insurance bureau scores.

Definition of Insurance Bureau Scores

A Fair, Isaac insurance bureau score is a predictor of a consumer's insurance loss potential based on information contained in the consumer's credit file at a particular point in time. More specifically, Fair, Isaac's scores are developed to rank order the applicant's or policyholder's likely loss ratio performance relative to other consumers. Fair, Isaac insurance bureau scores are available at the three major credit-reporting agencies and through ChoicePoint. (The credit reporting agencies have different product names for the Fair, Isaac insurance bureau scores they sell.)

Distinction Between Insurance Bureau Scores and Credit Bureau Scores

Fair, Isaac is frequently asked if there is a difference between the Fair, Isaac insurance bureau scores and the Fair, Isaac credit bureau risk scores (commonly referred to as FICO® Scores). While both types of scores use information from consumer credit files, they are designed to predict very different outcomes. The credit bureau risk models are built to predict the likelihood of delinquency or non-payment of credit obligations. Insurance bureau scores, by contrast, are built to predict future insurance loss ratio relativity and are discussed below, but not credit bureau risk scores.

Fair Credit Reporting Act

The Fair Credit Reporting Act (FCRA) allows insurers to use credit reports under the permissible purpose of "underwriting insurance." The FCRA also allows consumer credit information to be used for insurance prescreening in a transaction not initiated by the consumer, provided that the consumer receives a firm offer of insurance. However, the FCRA also permits making such an offer conditional, subject to the verification of the information in the credit report or application at the time of acceptance, in order to ensure the consumer still meets the prescreen criteria.

In addition, the FCRA stipulates that users of consumer reports must give notice to applicants or policyholders when adverse actions (such as denial of insurance or an unfavorable change in policy terms) are taken based on information in the report – the user must inform the consumer of the credit bureau used and of his right to get a free copy of his report in order to verify the information in it.

Also, the FCRA mandates a quick resolution for any errors found and reported to the consumer reporting agencies so that accuracy can be maintained.

Information Not Used in Fair, Isaac Insurance Bureau Scores

The Fair Housing Act (FHA) applies to residential real estate-related transactions, including homeowner's insurance. Fair, Isaac's insurance bureau score models comply with the FHA guidelines and do not take into account a person's race, color, religion, sex, handicap, familial status or national origin.

While the Equal Credit Opportunity Act (ECOA) does not cover the insurance industry, Fair, Isaac insurance bureau scoring models follow ECOA guidelines. Therefore, Fair, Isaac insurance bureau score models do not take into account any characteristic which is a prohibited basis as defined by the ECOA, including race, religion, sex, age, marital status, and public assistance source of income.

Moreover, the Fair, Isaac insurance bureau score models do not take into account the income or the address of the consumer.

Information Used in Fair, Isaac Insurance Bureau Scores

Fair, Isaac insurance bureau scores are based entirely on information from consumer credit reports. They evaluate five main categories of information:

1. Payment History
2. Amounts Owed
3. Length of Credit History
4. New Applications for Credit
5. Types of Credit in Use

The score takes into consideration numerous pieces of information from all five categories – no one piece of information or factor alone will determine the score. The score considers both positive and negative information in the credit report. For example, late payments will lower a score, but establishing or re-establishing a good track record of making payments on time will raise the score.

Development of Fair, Isaac Insurance Bureau Scores

Fair, Isaac pioneered the development of insurance risk scores based on consumer credit information in the early 1990's. The scores were developed by analyzing large samples of auto and home insurance policies to determine the statistical correlation between information on consumer credit bureau reports and subsequent insurance loss ratio. The development process included the following steps:

- **Fair, Isaac accumulated a historical development sample** of hundreds of thousands of automobile and property insurance policies from several national and regional insurers, which included specific information regarding premium and loss information. This information was used to calculate the loss ratio for each policy in the sample and for the overall population.
- **Fair, Isaac then had a consumer reporting agency append archived credit file information** for each match that could be found. Thus, this data reflected each consumer's credit file as it appeared at the time the policy was written.
- **Fair, Isaac developed separate models (or scorecards) for the major types of both auto and homeowner insurance.**
- **Fair, Isaac used advanced statistical modeling to empirically determine the correlation of hundreds of credit variables** (for example, the number of 60-day delinquencies in a credit file) **with insurance loss performance.** The credit variables that were determined to be most predictive of later loss performance were used to build the models. Attachment A contains examples of several credit bureau characteristics and their relationship to loss ratio relativities.

The final models rank-order the likely loss ratio relativity of individual new applicants at the time of application or, in the case of a policyholder, at the time of renewal. The scores are represented by a three-digit number, ranging from the 100's to the 900's. The higher the score, the lower the likely loss ratio relativity and the better the risk. The rank-ordering is illustrated in Attachment B.

Score Delivery: Although Fair, Isaac developed the algorithms and software used to generate insurance bureau scores, the score is calculated by the consumer reporting agencies based on the information in their credit databases, and the score is delivered by the credit reporting agencies to the insurer, along with the underlying credit report upon which the score is based.

Scoring Reason Codes

When an insurance company requests a Fair, Isaac insurance bureau score from the credit reporting agency, they receive not only the three-digit numeric score, but also a set of up to four score reasons which represent the factors in the credit file that had the greatest influence on the score. The score reasons are listed in order of importance, starting with the reason that had the greatest impact on the score.

Score reasons may include both positive characteristics (factors that have a favorable impact on the score) and negative characteristics (factors that have a negative impact on the score).

If adverse action is taken based on the consumer's insurance bureau score, Fair, Isaac recommends that insurers use the score reasons to provide consumers with more specific information on the reasons for the action. Since the score is based on consumer credit characteristics, communication with the consumer should include the score reasons.

Validation of Fair, Isaac Insurance Bureau Scores

The predictive power of Fair, Isaac insurance bureau scores has been validated many times, both by Fair, Isaac and by independent entities including the following:

- Tillinghast-Towers Perrin Study. This 1996 study, commissioned by Fair, Isaac, supported the relationship between credit data and loss ratio.
- Virginia Bureau of Insurance Study. This 1999 independent study, which used data provided by Fair, Isaac, concluded that there is a concrete statistical correlation between insurance scores based on credit bureau data and the likelihood of an individual filing an insurance claim. It also found that credit scoring would be an **ineffective** tool for discriminatory **redlining**, since neither race nor income alone were reliable predictors of scores. This conclusion supports the insurance industry position that use of credit information does not discriminate against women, minorities or any income group.
- American Insurance Association Study. This 1999 study by a member of the Association, which used Fair, Isaac insurance scores, concluded that the insurance score is not significantly correlated with income, and that, based on information available for AIA company's policyholders, there is no evidence that insurance scores based on credit bureau data unfairly discriminate against lower income groups.

Fair, Isaac Suggestions Regarding the Use of Insurance Bureau Scores

Fair, Isaac's insurance bureau scores are used by hundreds of leading insurers in the US and Canada to improve the speed, consistency, and objectivity of the risk rank-ordering process. By using scoring, insurers save resources, make faster approvals, and better manage their books of business.

Regarding the use of Insurance Bureau Scores, Fair, Isaac suggests that:

- 1) Insurers to use insurance bureau scores in conjunction with other important sources of information such as applications, motor vehicle reports and claims history reports. We do not suggest that insurers make pricing decisions based solely on insurance bureau scores.
- 2) Insurers to use insurance bureau scores to identify expected good performing risks in traditionally poor risk segments, and to identify expected poor performance risks in traditionally better risk segments. This allows insurers to

better understand the risk associated with these populations, and thus can provide more appropriate pricing.

- 3) Insurers that are evaluating insurance bureau scores to conduct a retrospective analysis to validate the strength of the models on their book of business and to determine pricing policies based on insurance bureau scores and other information.
- 4) Insurers to track and analyze the results associated with the use of the Fair, Isaac insurance bureau scores to monitor score distribution trends, measure the performance of the scores on their book of business, and refine their strategies.
- 5) State insurance departments allow modelers like Fair, Isaac to discuss modeling issues and when model disclosure is requested, protection for intellectual property should be provided. Trade secrets protection allows modelers to compete and bring better and better tools to the insurers to serve the markets. It is important that the public should not be allowed to access the models, learn of the characteristics in the models, and manipulate their credit behaviors for the only purpose of achieving higher scores. The lack of protection would lessen the predictiveness from these models and reduce competition.

Fair, Isaac does NOT:

- 1) Suggest penalizing applicants who do not have a credit history or for whom an insurance bureau score cannot be calculated.
- 2) Provide guidance regarding the specific business decisions and processes of insurance companies. Each insurance company determines how they will use insurance bureau scores based on their particular appetite for risk and regulations.

Summary

In closing, the primary reasons for the use Fair, Isaac insurance bureau scores to be a valuable tool for the insurance industry are as follows:

- **Legal.** Fair, Isaac insurance bureau scores are built based on credit information, the use of which is a permissible purpose as defined in the Fair Credit Report Act.
- **Proven.** Fair, Isaac insurance bureau scores are empirically derived, statistically sound scoring systems that demonstrate a strong relationship between credit data and insurance loss relativity.
- **Fair.** Only credit-related information is used to calculate insurance bureau scores. Fair, Isaac insurance bureau scores do not use as a characteristic any prohibited basis of comparison such as age, gender, familial status, religion, nationality, race, or handicap. The scores are carefully developed to balance all of the predictive characteristics, both positive and negative, from the credit report.
- **Consistent.** Because Fair, Isaac insurance bureau scores are usually applied in an automated environment and in combination with the insurer's rules and other criteria, all applicants are treated according to a consistently applied standard.
- **Accurate.** By using insurance bureau scores, underwriters have the opportunity to identify and price risks more appropriately than in the past they could not do so because of incomplete knowledge or information. For example, a good credit

history can offset negative factors, such as a poor driving record, and thereby enable someone to get proper pricing who might otherwise be charged more.

- **Efficient.** Fair, Isaac insurance bureau scores allow insurers to use their rating and pricing resources more effectively and thus lower operational costs.
- **Cost effective.** The use of insurance scores keeps the insurance marketplace competitive, resulting in lower prices and more choices for consumers.
- **Regulatory friendly.** Fair, Isaac discusses insurance bureau scores with regulators on an educational basis and on a model disclosure basis with confidentiality agreement in place.

Fair, Isaac stands by to answer any questions on the above on the use of credit information and scoring for auto and homeowner insurance.

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Attachments